

The PERAC Financial Bulletin

Financial Market Review, 2nd Quarter 2004

JULY 2004 | NO. 22



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nor bearish but, as one
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Q2

For those prognosticators who felt that investment returns in the current decade would be modest after the above-average gains for both stocks and bonds in the 1980s and 1990s, the first half of 2004 has been Exhibit A.

While continued instability in Iraq and the ongoing threat of terrorism still hung over the market, the economic outlook became much clearer on April 2 with the release of a much stronger than expected jobs report. With impressive jobs creation in the May and June reports providing further evidence that an economic recovery was indeed underway, it was also evident that the long bull market in bonds was coming to an end and that investors had to begin factoring the effects of rising interest rates into their investment outlooks.

EQUITY MARKETS

Still seeking direction after 2003's dramatic recovery from the three-year bear market, stock returns this year have been neither bullish nor bearish but, as one reporter noted, basically mulish, with little movement in either direction. As seen in the accompanying table, most broad market indices were modestly positive both for the quarter and for the first six months of 2004. The Wilshire 5000 Index, which tracks the entire US market, was up 1.3% for the quarter and 3.9% year-to-date. (Accompanying charts also show this year's market performance in the context of five and ten-year perspectives.)

Perhaps the major surprise in the market has been that, even after four years of out-performance, small cap stocks have continued to outgain large caps. The S&P 500 (large cap) Index did outperform the Russell 2000 (small caps) during the second quarter in the possible beginning of a trend

reversal, but small caps have outperformed by 3.3% year-to-date and by an annualized 8.8% over the past five years.

The differentials between growth and value have been less significant this year. For the quarter, growth did slightly better but value retains a modest advantage year-to-date. Over the past five years, value has an impressive edge of 8.7% in annualized return, according to Russell.

As always, there was diversity in stock returns. Among the Dow Jones Industrials, Boeing and Microsoft were up 24.4% and 14.4%, respectively, for the quarter while Walmart and Citigroup were down 11.6% and 10.1%, respectively. Perhaps reflecting investors' concerns over rising prices, natural resources was the best performing sector while real estate and financial services, two sectors possibly vulnerable to rising interest rates, were among the worst. In a sign that investors are seeking companies with healthy earnings, in contrast to the less established companies that did best in 2003, dividend-paying stocks have performed much better than non-payers this year.

Like their US counterparts, international stocks have also had

Chart 1

Meandering Market:
S&P 500 in 2004

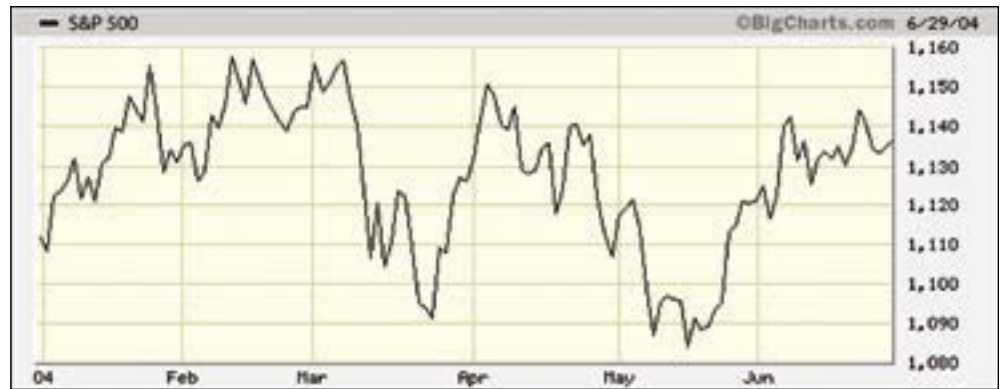


Chart 2

S&P 500: A Five-Year Perspective



Chart 3

S&P 500: A Ten-Year Perspective

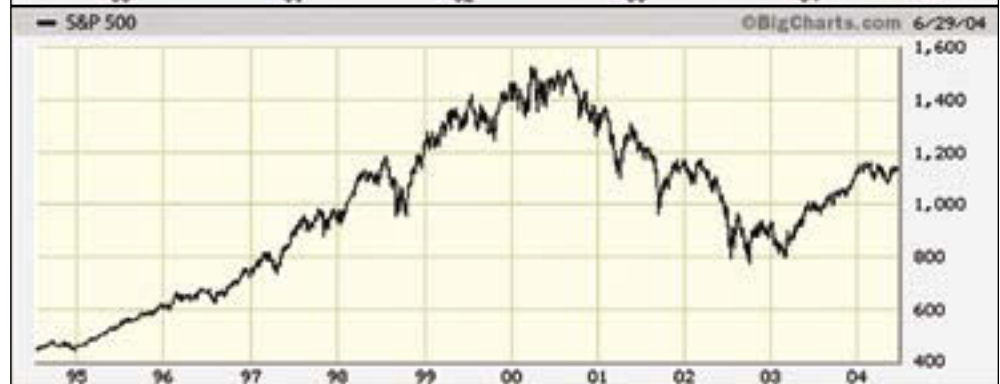


Chart 4

S&P 500 vs Russell 2000:
Small Caps Rule

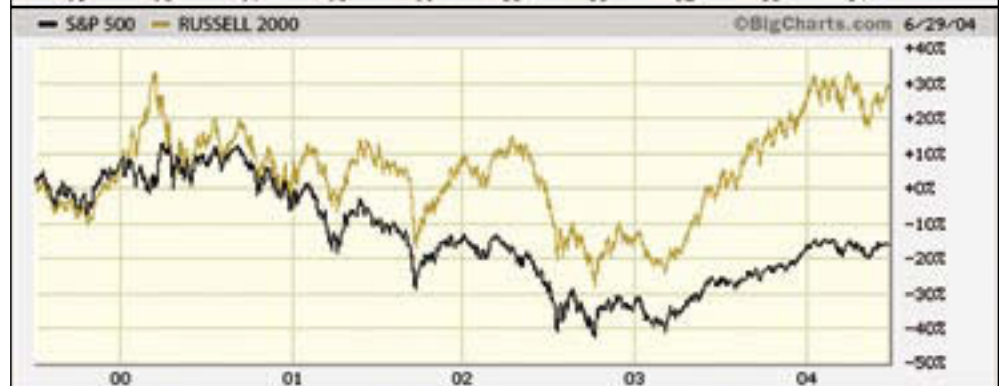
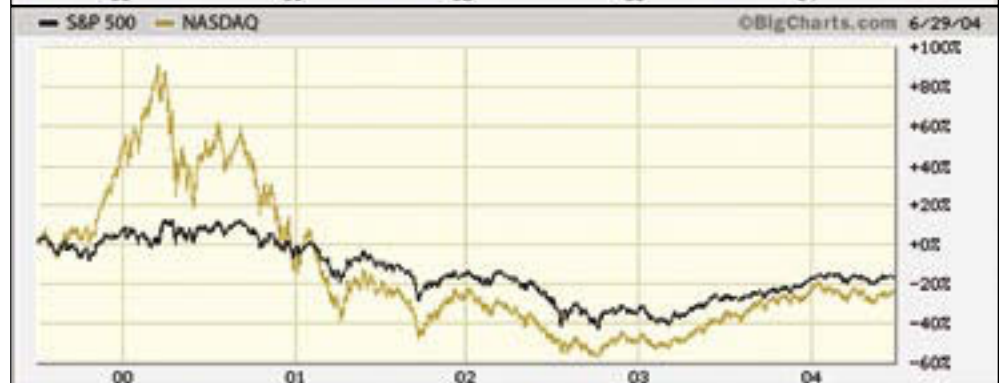


Chart 5

S&P 500 vs. NASDAQ:
Since the Bubble,
Trading About Even



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a plodding, directionless year. After many years of disappointment, Japan continues to enjoy an economic and market recovery while China, a significant engine of economic growth in recent times, was making explicit efforts to slow its rate of growth. After a basically flat quarter, the total return of the MSCI-EAFE Index for developed markets was up 4.6% for the first half of the year. Emerging markets, after a spectacular year in 2003, were down slightly during the first half of 2004 amid concerns over rising interest rates.

In the waning days of June, the stock market digested the handover of power to Iraq as well as the Fed's initial act of tightening, but as the third quarter began, the market had a weaker tone amid some indications of a slowing economy. If the economy were to slow from its healthy 4% first quarter growth rate, it might cause analysts to question their expectation of continued 20% year-to-year profit growth for large companies. The fact that price/earnings ratios are above historical averages is also a concern, as is the uncertainty over the Fed's future course given that interest rates, whose level are an important factor in stock valuations, remain historically low even after the initial tightening.

FIXED INCOME

The bond market had one of its worst quarters in recent years as the performance value of coupon income was offset by price depreciation caused by higher interest rates. Market values of existing bonds typically decline (or rise) when the overall level of interest rates rises (or falls).

In a move that was widely telegraphed by the Fed and anticipated

by the market, the central bank raised the federal funds rate by 0.25% to 1.25% on June 30. This reversed the pattern of thirteen reductions over three years that had brought the key rate to its lowest level since 1958. In an accompanying statement intended to reassure the market that a series of sharp hikes in interest rates was not likely over the coming months, the Fed stated that it expects the rate of future rate adjustments to be "measured". With some indices showing prices now rising at rates of at least 2-3%, there was some concern that, with the fed funds rate still well below the inflation rate, the Fed was not acting decisively enough to ward off possible inflation.

As is typical, the short end of the yield curve bore the brunt of the rise in rates during the second quarter. At 2.7% and 3.8%, respectively, at quarter-end, yields on the 2 and 5-year Treasury notes both rose by over 100 basis points from their lows of earlier this year. The benchmark 10-year Treasury note, which had declined in yield from 4.25% to 3.85% during the first quarter, rose in yield to 4.6% by the end of the second quarter. Thus, the shape of the yield curve has flattened during the course of this year.

In terms of quality spreads, prospects for an improving economy have allowed the spread between high grade (Aaa-rated) and medium grade (Baa-rated) bonds to narrow this year, as would be expected. However, corporate bonds overall have not held up appreciably better than Treasuries. After declining 2.44% during the second quarter, the return on the Lehman Brothers Aggregate Index (which includes mortgage-backed securities and investment-grade corporate bonds along with Treasuries) is just 0.16% year-to-date. Despite the benefits of their high coupons and an improving economy, high yield "junk" bonds, which had an excel-

lent year in 2003, have also been only modestly positive this year.

ALTERNATIVE INVESTMENTS

Real estate investment trusts, after very strong performance in 2003 and the first quarter of 2004, declined 5.8% during the second quarter in an expected reaction to the prospect of higher interest rates. Nevertheless, equity REITs are still up 5.5% year-to-date.

Privately held real estate, having significantly trailed REITs in performance over the past year, appeared to be closing the gap as quarterly returns for the most recently reporting four quarters, reflecting the effect of an improving real estate market, indicate that annualized performance has risen to 9.7% from about 7% a year ago.

The reporting of returns for venture capital is lagged by several months, but it is evident that the market is clearly returning to normalcy. The second quarter had 58 Initial Public Offerings, versus only 5 in the first quarter of 2003. The 102 IPOs, representing \$18.76 billion, that came to market during the first half of this year have already eclipsed the 83 IPOs, representing \$15.33 billion, that came in the twelve months of 2003. About half of the IPOs coming to market in recent months have been venture-backed, and most of the new offerings have been in the life sciences industry. Performance of IPOs has been described as solid but tame. Activity remains well below the pace of the boom years of the late 1990s, but market participants are very hopeful about the trends.

Hedge funds proved themselves to

Chart 6 | After a Long Decline, Interest Rates Begin to Rise

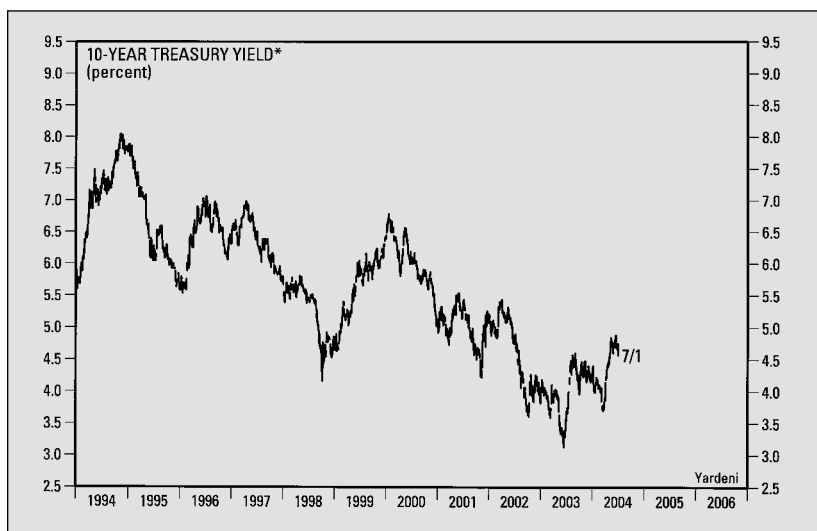


Chart 7 | The Yield Curve Flattens

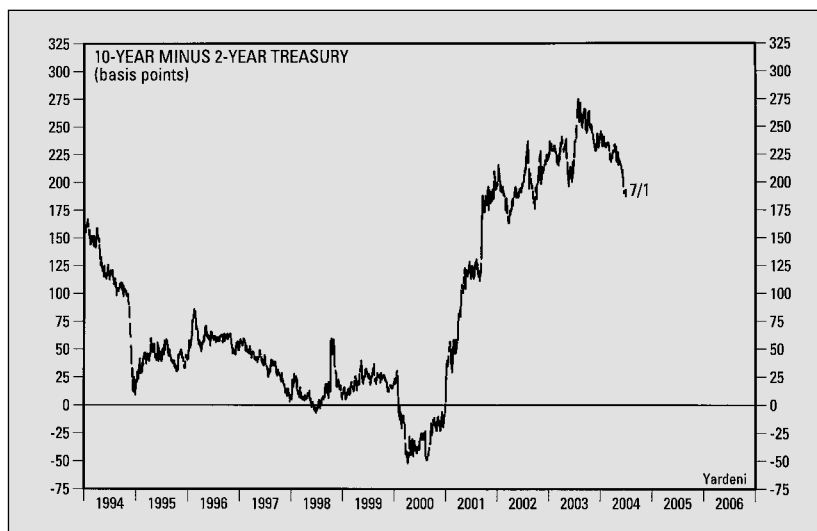
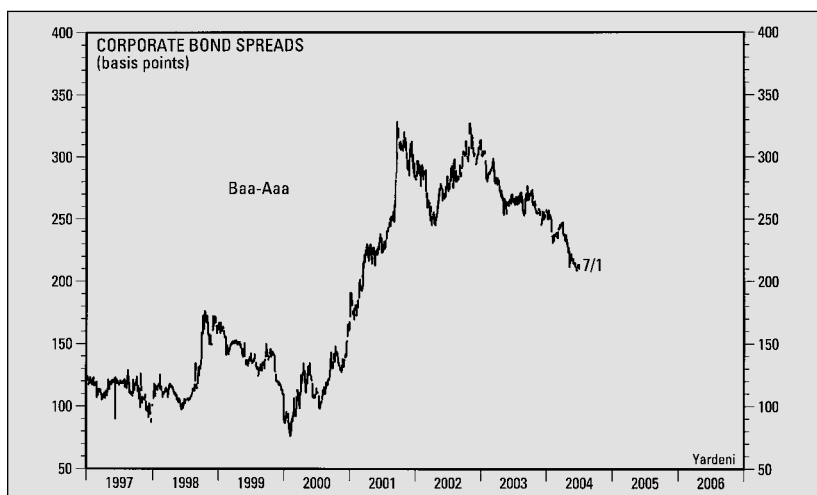


Chart 8 | Quality Spreads Continue to Narrow



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have strong diversification benefits during the 2000-2002 bear market, and they also had solid positive returns during 2003's strong market rebound. However, they have so far proven to have little marginal value during the flat market of 2004. Returns on the most widely followed hedge fund strategies have themselves been basically flat to only slightly positive during the first half of this year. The industry has not seen any major blow-ups despite the industry's continued rapid growth. Nevertheless, the SEC is reportedly poised to establish some form of regulatory requirements on hedge funds over the coming months.

With stocks fully priced relative to earnings, bond prices vulnerable to further rises in interest rates, and no other asset class appearing undervalued, the investment outlook is as uncertain as it has ever been, particularly when such factors as Iraq, terrorism, the economy, oil prices, and the US presidential election are considered. In this environment, there are no easy investment panaceas. There is only the continuing need to maintain well-balanced portfolios and to carefully monitor all investment managers.

As always, the PERAC Investment Unit welcomes the opportunity to work with retirement boards and to provide assistance in any phase of their investment program.

TOTAL RETURNS | *2nd Quarter, 2004*

INDEX		SECOND QUARTER, 2004	SIX MONTHS, 2004
US EQUITY MARKET			
Dow Jones Industrial Avg.	+	1.24%	+ 0.80%
Standard & Poor's 500 (Large Cap)	+	1.72%	+ 3.44%
NASDAQ Composite	+	2.70%	+ 2.22%
Wilshire 5000 (Broad Market)	+	1.29%	+ 3.93%
Standard & Poor's Mid-Cap 400	+	0.97%	+ 6.09%
Russell 2000 (Small Cap.)	+	0.47%	+ 6.76%
GROWTH VS. VALUE			
S&P 500 Growth	+	2.69%	+ 2.72%
S&P 500 Value	+	0.80%	+ 4.17%
S&P Midcap 400 Growth	+	0.76%	+ 5.35%
S&P Midcap 400 Value	+	1.19%	+ 6.78%
Russell 2000 Growth	+	0.09%	+ 5.68%
Russell 2000 Value	+	0.85%	+ 7.83%
INTERNATIONAL EQUITY			
M.S.C.I. - E.A.F.E.	+	0.22%	+ 4.56%
M.S.C.I. - Emerging Markets	-	9.64%	- 0.97%
FIXED INCOME			
Lehman Brothers Aggregate Index	-	2.44%	+ 0.16%
First Boston High Yield Index	-	0.19%	+ 2.48%
REAL ESTATE			
NAREIT - Equity Real Estate Investment Trusts	-	5.81%	+ 5.51%
NCREIF Property Index	+	2.56% (Q1)	+ 9.71% (Trailing 12 months)

